

UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT

SME Support Project

Expanding Access to Finance

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Review of the key impediments to access to finance in Bosnia-Herzegovina and recommendations for elements to be included in the SME Support Project.

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Development of the Financial Sector

Market Depth

The Bosnia-Herzegovina (BiH) financial sector has been growing rapidly. Loans to GDP have expanded from 14% in 2003 to 27% in 2007, as shown in Figure 1 - Loans as a Percentage of GDP for the period 2003 to 2007, with the 2007 figure extrapolated from November data.

Annualized monthly loan growth for the first eleven months of 2007 peaked in April at an annualized rate of 45%, but has settled down to a more sustainable rate of around 25% per year, as shown in Figure 2 - Annualized growth in Loans to the Private Sector. This is rapid growth by any measure, even though recovering from a low base, with capacity within lenders likely to be a major constraint as a shortage of bankable clients if credit quality is to be maintained.

Growth has predominantly been in loans to private sector business and individuals, as shown in Figure 3 - Private Sector Loans in 2007. Loans to individuals and companies have been growing in tandem from KM 1.5 billion each in 2002, while loans to other categories are becoming less significant with rapidly declining market share.

This growth is consistent with the rapid expansion in banking offices – a brief walk around the town center showed some two dozen ATMs plus three banking office where ATMs were not visible. Rapid entry of foreign banks into what is a small market of only some four million people would have created a very competitive environment and a need for rapid growth in earning assets to justify the substantial investment in modern bricks and mortar.

Even with the import of modern policies and procedures, automation, financial and management expertise, developing a BiH cadre of qualified lending and operational staff takes time - expansion ahead of staffing capacity can (and usually does) lead to control and quality problems. Acquiring and training staff, using internal training facilities within sister organizations, is viewed as less of a challenge that retaining those staff once they are trained, indicating a tight market for qualified bank personnel. Expansion of credit for trade finance and the productive assets needed to expand capacity for exports may well require cut-backs in other

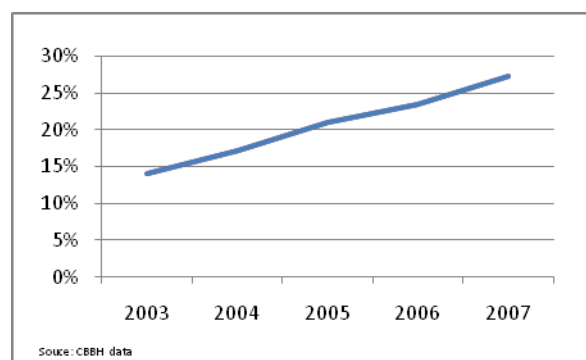


Figure 1 – Loans as a Percent of GDP, 2003-2007

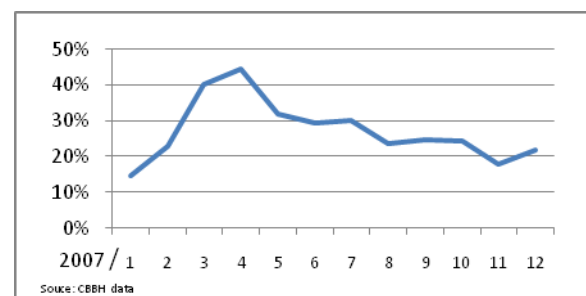


Figure 2 - Annualized growth in Loans to the Private Sector during 2007

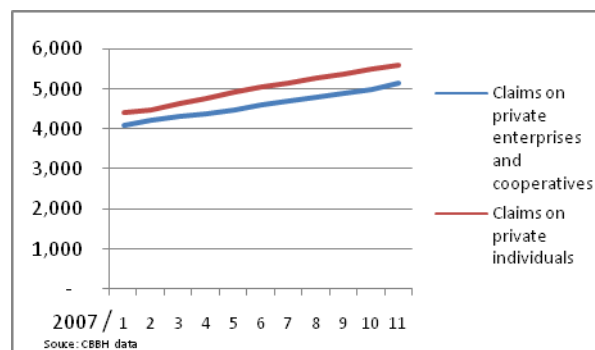


Figure 3 - Private Sector Loans in 2007 (KM millions)

areas that at the moment may seem more attractive. Such a change in the composition of the banks' loan portfolios would require that trade related finance become more financially attractive to lenders than the current alternatives. Reducing the risks in trade related finance would be a major step in this direction.

Figure 4 shows that short term lending has been growing slowly, but more strongly for private sector enterprises and cooperatives. Long term lending, on the other hand, has soared, particularly for individuals – probably heavily vehicle loans – as shown in Figure 5¹.

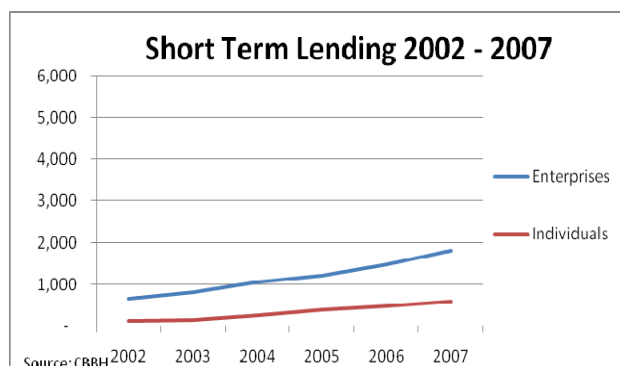


Figure 4 - Short Term Lending 2002 – 2007 (KM millions)

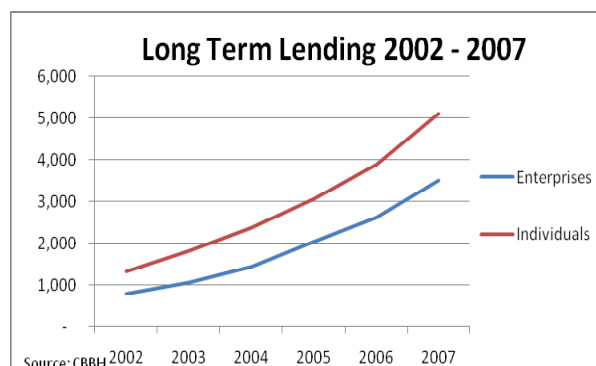


Figure 5 - Long Term Lending 2002 – 2007 (KM millions)

Prudential regulations limit the extent of maturity transformation (use of short term funds for long term lending) – this does not seem to be inhibiting term lending growth.

[Is leasing included in these statistics?]

Bank Capital Adequacy

The BiH banking system appears over-capitalized. The ratio of capital to total assets (which understated capital adequacy, since this includes all assets without risk weighting) is shown in Figures 6 and 7.

This high capital adequacy ratio² implies that the banks are not able to adequately leverage their capital, increasing pressure to expand earning assets as fast as staffing and market opportunity permit, and to rely heavily on fee income to generate an adequate return on equity. Given staffing constraints, proliferating credit products is likely to seem less attractive than maximizing reliance on existing products as long as market absorptive capacity for the existing products continues unless there is a significant shift in the risk/reward factors, at least until staffing capacity deepens.

¹ Year end 2007 data extrapolated from November 2007 data.

² The standard minimum capital adequacy ratio according to Basle I is 8% of risk weighted assets. Risk weighted assets would be less than total assets by the amount that is risk weighted at less than 100%, but offset by the amount of risk weighted off-balance sheet liabilities that could become claims on others (assets) if realized.

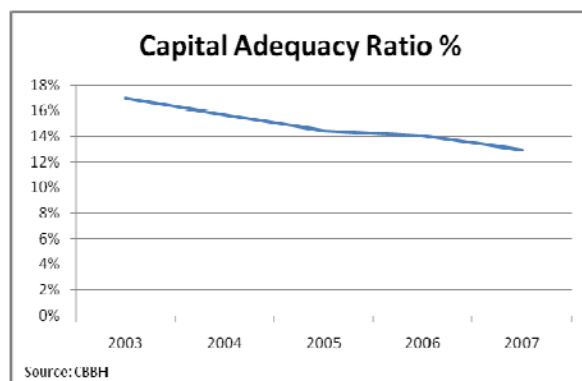


Figure 6 - Capital to Total Assets, 2003-2007

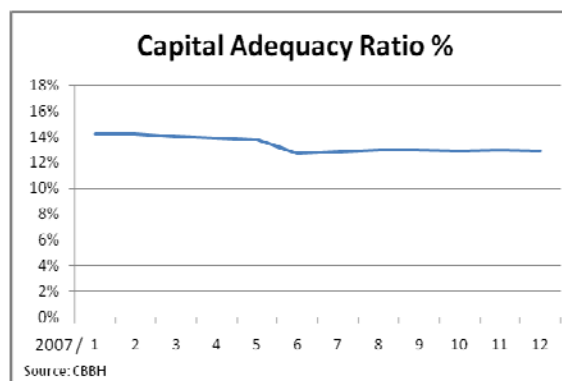


Figure 7 – Capital to Total Assets, 2007

One bank confirmed that it is rethinking its approach to its asset management. With all the banks chasing the best clients and its finding that going down market while following corporate lending credit management practices is not economically viable, it is looking at restructuring its SME lending to raise the limit above which it will conduct full credit analysis, while introducing a more statistically based system of credit scoring on credits below this threshold.

Profitability

Liquidity

Bank liquidity in BiH, as measured by deposits in the bank's liquidity reserve accounts with the CBBH, has consistently been over 50% higher than the mandated requirement, as shown in Figure 7. Deposit growth and liquidity have grown steadily during the year, with no indication of seasonality. Short term resources do not appear constrained – although since most of the banks are part of a larger network, cash management within the group will enable liquidity in BiH to be managed. Interest paid on the excess liquidity is 11%, compared to only 1% on the mandatory liquidity reserves. Raising the liquidity requirement – one way of tightening money supply to restrain lending and inflation – serves more to reduce the amount of interest the CBBH must pay to the banks.

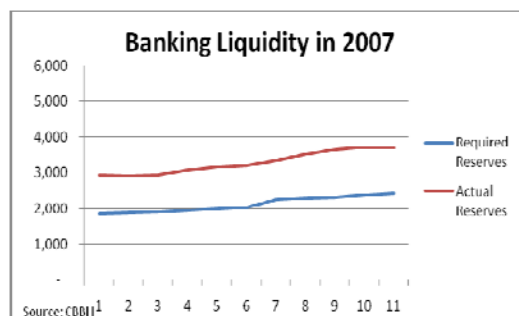


Figure 7 – Bank Liquidity in 2007 (KM millions)

Key Market Constraints

Credit Bureau

A private credit bureau was established and was operating, apparently effectively. It included positive and negative information, plus credit character information from outside of the banking system, including utility payments. However, two of the larger banks refused to participate, as did some of the micro-finance institutions. This lack of full participation ensured that credit

information provided by the credit bureau was likely to be incomplete, and thus unreliable. Assuming that this credit bureau was duly licensed by the Central Bank, one option to ensure its function would have been for the Central Bank to require that all lending institutions provide data to all licensed credit bureaus, thus ensuring complete coverage.

However, the Central Bank, with USAID support, established a separate credit bureau with full participation by the banking community, housed in the CBBH. This has been working well, and provides full (although not necessarily timely or accurate) data from all banks, and is now used by the banking community to check credit backgrounds. In principle, data on exposure to individual banks is camouflaged using codes, but in practice it did not take long for the banks to figure out the codes used for each reporting institution. However, this system

- does not track data from other sources, such as utility companies, so provides no assistance to first time borrowers;
- is not linked in with the international credit bureau network, so cannot provide the cross border checking necessary for a lender to evaluate whether to discount an export receivable; and
- has undercut the usefulness of the existing private sector credit bureau, essentially making it irrelevant.

It is also unlikely that the Central Bank's system provides the credit scoring and data mining that are essential attributes of effective private sector credit bureaus. *[This needs verification]*

On discounting export receivables, those banks that are part of an international network could in principle establish an efficient process for feeding credit inquiries into its appropriate sister institution to obtain a credit check. At least one of the banks that has this capacity has not yet implemented such a process.

A full service, comprehensive credit bureau is essential to informing the credit decision making process, particularly for new clients that do not have established banking relations. BiH has traded full service for comprehensiveness. The result is that borrowing by new market entrants is made more difficult, since demonstrated reliability in honoring obligations other than bank loans cannot be used to demonstrate character. BiH could benefit from either combining these two systems or alternatively expanding the Central Bank based system into a full commercial credit bureau, possibly with one or more international partner(s) that could provide access to credit scoring and data mining expertise and cross border capacity.

Leasing

Leasing provides finance for plant and equipment while enabling the lessor to retain title to the object that is financed, enabling simplified, non-judicial recovery of the property if the lessee fails to meet the payment schedule. In BiH, vehicle leasing encounters three potentially terminal challenges:

1. The vehicle registration process serves the additional purpose of evidencing ownership, and only the registered party may legally operate the vehicle. As a result:
 - a. A leasing company may not register the vehicle in its own name, since only employees of the leasing company would be legally allowed to operate the vehicle, thus excluding the lessee.
 - b. Registering the vehicle in the lessee's name so that the lessee can operate the vehicle effectively also conveys ownership, eliminating the lessor's ability to repossess the vehicle.
2. The work around has been to structure the lease as a loan and registering a lien through the movable property registry – but new legislation in RS prohibits this approach. And in any case it eliminates non-judicial repossession and also the transfer of the tax benefit of depreciation, both of which are the major economic justifications for leasing.
3. The legislation enabling non-judicial registration of liens through the movable property registry specifically limited access to banks. Logically, this facility should be equally available to all duly licensed financial institutions, which would include leasing companies.

In principle, having a combined title and registration system should work, but it should enable the lessor as owner to register the vehicle in the name of the lessee while recording retention of ownership by the lessor³. This should allow the lessor to repossess the vehicle extra-judicially in case of failure of the lessee to conform to the terms of the lease⁴, and should prevent the registered operator from transferring ownership to a buyer as long as the record shows the lessor as owner⁵.

Leasing of real estate also is impaired, although not terminally, by the requirement that the property transfer tax be paid twice, once when the leasing company purchases the property on behalf of the lessee, and again at the end of the lease when title to the property is transferred to the lessee on completion of all payments. Since the lessor will have incorporated the property transfer tax into the lease payments, the lessee will already have paid the tax in full by the end of the lease, and requiring duplicate payment represents double taxation on a single transaction.

Leasing has proven to be a very effective component of the financial sector that opens access to finance for plant and equipment by spreading the cost for the user over the useful life of the asset while protecting the financier by enabling non-judicial contract enforcement. It would seem in the interests of economic development in BiH for the Government to ensure that unnecessary impediments are not placed in the way of this transaction type.

³ Or record of the lien in the case of a secured bank loan.

⁴ Or the bank lender to exercise foreclosure in case of failure to comply with the terms of a bank loan.

⁵ Or the bank as lien holder.

Lending Practices

Financing export trade occurs in three stages, working backwards from the buyer as source of payment:

3. Receivables Finance

The buyer will have to hold purchased goods in inventory until they are sold to the consumer. Financially strong buyers can finance the inventory carrying cost based on their own credit standing as self liquidating cash flow lending supported by their balance sheets, and if necessary with the inventory as the secondary source of repayment. The financing cost may be at or close to prime, given the credit standing of the borrower, so will be cheaper than financing the BiH exporter is likely to obtain.

However, financially weaker buyers may require differed payment terms, typically 30, 60 or 90 days to pass the inventory carrying cost back to the BiH exporter, which may be required to provide such sales terms in order to be competitive. This is where the challenge currently lies for BiH small exporters. The credit decision by the BiH bank to advance the funding is based on the following factors:

- Confidence that the buyer will pay when due. Given that the BiH credit bureau system is not linked with similar systems in the buyer's country, the BiH bank has no easy way of checking the credit standing of the buyer. For large transactions, a credit inquiry can be sent to the buyer's bank, or a sister bank in the buyer's country may be asked to access the local credit bureau – but this is time consuming and costly.
- If the buyer does not pay when due, or the payment is diverted from the seller's bank, then the second way out is for the seller's bank to charge the buyer's account, possibly advancing funds through a loan account if the deposit account is not sufficient to cover the obligation. This requires confidence in the BiH seller's financial condition and performance. For a large company, this is not an issue – accounts will be audited by a major firm and the business volume will justify the cost of the bank's credit analysis. However, for a smaller company with less certain accounts and volume too small to justify the cost of the credit analysis, this can be a significant impediment.

Certainty of payment can be improved through the buyer having its bank open a letter of credit (L/C) in favor of the BiH seller, advised through the seller's bank, that provides for differed payment terms. This way the BiH bank can look to the credit standing of the opening bank, which is easier to evaluate. The downside is that this process incurs bank charges, typically ¼% per quarter (three months) for the amount of the L/C, plus advising and negotiating fees, which lessens the price competitiveness of the BiH exporter. Also, since most trade within Europe is conducted on an "open account" basis, the buyer may resist requesting its bank to open an L/C on principle.

In addition, there is a performance risk on the seller – if the goods shipped prove to have failed to meet the buyer's specifications or EU standards, the buyer may refuse to make payment based on breach of the sales contract.

So even sales to an “undoubted” buyer are not certain until the cash is received, requiring the BiH seller’s bank to look carefully at the credit standing of its exporting client.

2. Pre-export Finance

If a BiH small company receives a significant order from a European buyer, it may find that it does not have the financial resources to procure or produce the goods to be shipped. This requires pre-export finance, where the BiH seller’s bank advances the funds needed based on the sales contract that, if fulfilled, will provide the source of repayment. Here, not only is the buyer’s credit standing important, but the BiH seller’s capacity to actually produce and deliver the goods in the sales contract represents a significant performance risk that the seller’s BiH bank must believe is acceptable. This requires an established relationship of trust, and a thorough knowledge of the seller’s operations and capacity.

1. Inventory Finance

If the seller is not strong enough to justify pre-export finance, then the fall back position can be inventory finance. The seller accumulates the goods to fill the sales contract, using its own funds. But as inventory builds, it recovers part of its investment by financing that inventory. The first repayment path (way out) is for the seller to complete the sales contract, ship the goods, converting the inventory finance into receivables finance, with repayment to the bank occurring once funds are received from the buyer.

For this to be bankable, the goods accumulated in inventory must have a readily definable market value. In evaluating the recoverable liquidation value of the pledged inventory, the bank has to assume that the sales contract may not be completed, and that the inventory will have to be repossessed and sold, probably at auction. Such sales are typically at a lower price than that quoted in the sales contract, and in the case of specialized goods where there is a limited secondary market, or perishable goods, the recoverable value may be significantly lower. In addition, foreclosing on and selling collateral is a time consuming and expensive proposition.

Since the realizable value of the collateral will generally be less than the cost, the bank will lend only up to a percentage of the value of the goods. As an example, non-perishable commodities, such as grain, stored in a certified public warehouse that ensures certainty of quality, quantity and access through a warehouse receipts program may finance up to 80% of the value calculated at the price low point during the season. Inventory stored on the seller’s premises require periodic inspection to ensure that the quantity and quality meet the loan criteria, and repossession becomes more complicated since the goods may have to be physically removed from the seller’s property in case of default. If the bank does not have the technical staff qualified to inspect and value the inventory, or the law does not permit automatic right of access to the seller’s property for inspection or repossession, or the law requires lengthy court proceedings for the bank to assume ownership control over the inventory, the bank may find that the inventory has little real value as collateral.

Key then to inventory finance is the degree of certainty that the BiH seller will be able to sell the goods and receive payment in the normal course of business, backed by the degree of confidence that the goods can be seized and sold if that becomes necessary. The evaluation of

these factors is costly, and will mitigate against financing for smaller companies where the bank cannot reasonably recover these costs through fees and/or interest differential income.

Other forms of finance include:

Cash Flow Lending

Rather than relying heavily on the underlying commercial transaction and the goods involved, cash flow lending is based on evaluation of the borrower's financial condition and performance. This requires a good understanding of the borrower's business supported by reliable financial statements that accurately reflect past performance and can be used to project future debt service capacity. For larger companies, this is a viable form of finance, since the size of the banking relationship will justify analysis of the borrower's business and financial statements. In larger markets where there are a significant number of companies operating in the same economic segment, the bank may have industry specialists that develop a clear understanding of the particular industry and can evaluate an individual company's performance with that industry context. The wood industry or auto parts manufacturing might be suitable sectors in BiH. Again, size matters. Smaller companies, particularly those that are closely held or family controlled, are likely to be more opaque⁶ and the auditing that the company can afford may become less reliable, increasing the level of on-site analysis that the lending officer must undertake.

Equipment Finance

Product quality is a significant issue in BiH. Traditional production methods may not meet EU standards, and improving quality may require significant investment in new equipment and processes. Equipment leasing has often been an effective approach, particularly where the equipment is sufficiently general that there is a reliable secondary market, and where it is stand-alone so has limited unrecoverable installation and removal costs. As detailed on Page 6 - Leasing – the legal and regulatory environment for leasing in BiH does not adequately support this type of financing, to the detriment of economic development in BiH and particularly to the development of small and medium BiH enterprises that typically should be the major source of jobs and wealth generation.

Agricultural Finance

The LAMP work has focused on enabling access to finance to agribusiness, with 77 loans developed including 35 that originally required a DCA guarantee to tip the balance in the credit decision making process, but to whom the banks now lend without the guarantee⁷.

⁶ Full disclosure of income has incurred a tax liability. The income tax rate is being dropped from 30% to 10%, which may be enough to sufficiently remove the incentive for tax avoidance that financial statements can become more reliable.

⁷ This case is a clear example of successful use of DCA as a market opening catalyst, with the exit strategy being that it becomes unnecessary as the banks become comfortable with the clients involved. Three claims for losses were received, all paid, so maintaining the credibility of the DCA guarantee. The

The experience of the LAMP project has been that the banks in BiH are not equipped to handle seasonal loans. Their loan systems are designed to amortize loans at a fixed amount at fixed periods over the life of the loan. Matching the loan disbursements and payments with the seasonal cash flows of agricultural lending is apparently not possible, particularly for financing of orchards, where it may take three to five years before the trees mature enough to start generating cash, requiring an extensive grace period before loan payments can start.

Financing of primary producers is lagging. Some provision of in-kind supplies is being made by agribusinesses that depend on primary producers for their feed-stock, but payment for crops delivered to the processors only occurs after the processor receives payment from its clients, which can be up to 120 days later. This lack of financing for expanding primary production, and for improving quality control (particularly for milk) to EU standards is a significant constraint on the expansion of agricultural production and both exports and import substitution.

An open question is the size of the potential market for primary producer financing. A commercial bank looking at entering this market, or for a specialized agricultural bank, such as the Rabobank, to set up operations in BiH, would require a cost/benefit analysis that would identify the potential market and earnings opportunities that would justify the cost of market entry. Conducting such a market study, possibly in collaboration with one or more of the local agricultural training institutions, could be useful in opening this market.

Real Estate as Collateral

Small companies, particularly start up companies, typically rely heavily on the value of existing personal property owned to collateralize borrowings. For real estate to become a reliable source of financing for small family owned companies, the following must apply:

- **Certainty of Ownership:** the owner of the property must be able to demonstrate clear title, free of conflicting claims, with any existing liens (pledges to other lenders) clearly identified and limited to the amount of the funding available. This is essential to determine the nature and location of the property and pre-existing, higher ranking claims on it.
- **Certainty of Marketability:** for real estate to serve as collateral, the law must enable rapid and predictable foreclosure while reasonably protecting the rights of the owner, and a viable secondary market must exist that will allow the lender to sell foreclosed property.
- **Certainty of Market Value:** reasonable valuation of the property as collateral requires that there be a system that records sales transactions of similar properties in like condition and surroundings to that a reasonable assumption can be made on the likely realizable value, should the property be foreclosed and sold.

amount of claims has been slightly less than the Mission contribution to the guarantee fund, so the risk was reasonably assessed at inception of this program.

GTZ has been supporting the development of a cadastre system that will enhance certainty of ownership and transferability when properties are sold. An internet based Land Registry is being implemented. USAID's development partner, the International Real Property Foundation, has been supporting establishment of the real estate industry, including implementation of the Bosnia Real Estate Business Association (BREBA), which will enhance marketability and valuation. These activities will improve the certainty of realizable value of real estate as collateral for lending, and will open access to finance while improving the loan to value ratio⁸.

Feed back from market participants varied –

- The new notary system improved the efficiency of the title transfer process, with no court involvement necessary, but at a substantially increased cost. The old court fees were some 100 MK, while the new fees are based on the value of the property, starting with a legally prescribed floor of 1,000MK.
 - Since these fees are legally prescribed, there is no competitive pressure to bring them down – the assumption was that these notaries would do very well financially.
 - Since the fees are based on the value of the property, both buyer and seller have a vested interest in understating the sales price. This distorts price discovery for valuation purposes and undermines the base for real estate taxes.
 - Given the high cost of both sales transactions and pledge registration, there is strong incentive to avoid formally recording transactions unless absolutely necessary, which undermines the rationalization of property rights.
- The new registration process may actually have complicated real estate transactions. The old system, requiring judicial approval, was slow but well understood and worked. The new system that brings in a notary to approve transactions adds an additional layer, since the old system has continued. Since the notaries and judges do not have to accept each other's rulings, transfers of title have been substantially complicated, with the new notaries acting as expensive choke points. Some notaries have taken to putting disclaimer clauses on their documents to the effect that the document may not conform to the law, but is what the particular judge is demanding. The impact of this is shown in Sarajevo, where there is substantial demand for real estate but supply is blocked by the current convoluted process, resulting in prices that match those in London, according to a leading local real estate professional.
- The Land Administration in B&H Newsletter indicated that the new internet based Land Registry had been successfully tested in the Municipal Court in Sarajevo, indicating that the court system is indeed still involved.

⁸ The amount that can be lent on a property based as a percentage of its value.

- The new cadastre system is an attempt to automate the process that dates back to the late 19th century, rather than using IT to rationalize the underlying process. This is complicated since many of the property registries were destroyed during WWII, and never reconstituted. The new system thus has incomplete or inaccurate data on the location of properties, outdated or inaccurate descriptions, and little or no information on ownership. The banking system had been using a system they rated as much more effective that provided much better information, but the government was encouraged to replace it with the new cadastre. The result is that much of the property is not recorded in the cadastre, making it unavailable for use as collateral without a substantial risk premium that would serve as a form of title insurance.

Some confusion on implementation and the impact of a change in the process is to be expected. The market rationalization process initiated with GTZ support needs to continue to ensure that the real estate market is opened up. Linking the GTZ project with IRPF's activities and those of the BREBA could help to identify areas that need further work, such as ensuring that progress is made on updating the data in the system, that the notary process is not contradicted by the courts and that pricing is rationalized to enable competition and avoid distorting the market.

An additional issue is lack of clarity on zoning. Building permits are subject to municipal approval, but the municipality is subject to direction from the planning commission [is this municipal, cantonal, entity or state?] – these development “plans” appear to be constantly under revision, during which there is no certainty of what zoning rules apply. Adding certainty would require that existing plans stay in force and be publicly available until such time as a change is approved – any work authorized prior to the change should be “grandfathered”, meaning that authorizations are final and not subject to revocation by subsequent changes in the development plan.

A side effect of the lack of a functioning real estate market may be that the market value of properties could be up to several hundred times the original cost, which is all the public sector appraisal process uses to assign value. Value discovery through a multiple listing system that would track property sales and values to enable determination of market based orderly liquidation market value, alternate use value and replacement cost – the three usual approaches to valuation, would enable banks to rely on more informed property values in determining collateral coverage, thus expanding access to finance, and at the same time present a more rational basis for property taxation needed to fund municipal services. More rational property taxation would encourage property owners to use the property for its most productive purpose.

Public confidence in the certainty of title to property and in reasonable limits to the risk of pledging that property in order to support financing is a critical component of opening access to finance and, by lowering the risks for all concerned, lowering the transaction and risk premium costs.

Company Registration

Difficulties registering a company present a major deterrent to formalizing businesses – and since loan agreements are only enforceable if signed by duly authorized representatives of legally constituted companies. DfID has been supporting improving this process, and has managed to ensure that registration times have been reduced from months to weeks. However, as with the property registry, the focus was on automating a paper based process rather than automating the objective. Bosnia scores way below other countries in the region on this issue and the level of general frustration with the effectiveness of this system may have reached a sufficiently high level that the political will to institute a more modern system design may be developing. Also the success of the movable property registry, which did automate the objective rather than the existing process, is a clear demonstration of what can be accomplished. It may be appropriate to collaborate with DfID on taking this reform process to the next level.

Financial Transparency

Apparently there is plenty of accounting software available in BiH, both locally produced and at least one illegal copy of Quicken Home and Business 2004. Any company that wants to implement corporate accounting can do so – the disincentive has been the corporate tax of 30% and the social tax of 58% on staff payroll. With the corporate tax dropping to 10%, the incentive for tax avoidance is diminished, but the social taxes still act as a powerful deterrent to transparent accounting practices and job creation.

Given the high level of informality and tax avoidance, the tax authorities are understood to assume guilt unless proven otherwise. While this may not be an invalid assumption, the result is an intrusive tax inspection system and expense documentation process that is intended to screen out improper expenses by requiring irrefutable proof from the recipient of any cash that the expense incurred is a legitimate business expense through duly stamped invoices and receipts. The cost of obtaining and recording such receipts may exceed the expense incurred, which logically reduces taxable income through the incremental labor cost incurred (or diversion of labor from taxable income producing activities), so may be counter-productive. Setting a threshold below which receipts are not required, as is the practice in other countries, could facilitate small petty cash expenses without any meaningful loss of revenue to the tax authorities.

BiH has introduced a VAT at 17%, including the ability to claw back VAT as the goods are passed on. Anecdotal evidence suggests that attempts to legitimately claw back VAT result in visits by the tax inspectors that take up inordinate amounts of management time, resulting in businesses deciding that giving up the VAT is less onerous than the disruption of business that results from trying to recover it. The effective VAT tax rate is thus much higher than the nominal 17%.

But understating income and opaque accounting undermines potential borrowers' ability to document debt service capacity to a potential lender, and is a major impediment to expansion of

access to finance, particularly for smaller companies that can operate effectively without formal internal management information systems.

The high social charges also discourage formal employment and act as an incentive for companies not to grow so as to stay under the radar.

Business Planning

Local consulting services are available to SMEs to assist with development of business plans as support for credit applications. However, these are judged either to be expensive or formulaic, in the former case out of reach for an SME that is just reaching the point of applying for credit, in the second case easily recognizable by potential lenders as being off-the-shelf plans that the SME presenter may not even understand.

Missing Middle

One of the banks visited is undergoing a rethink of its business model, looking at moving down market, given the current crowding at the top and competitive pressure on lending conditions. This is likely to be a general trend, given the excess capitalization in the banking system.

At the other end of the spectrum, micro-finance institutions (MFIs) have been highly successful and the market has become somewhat crowded, leading to competition on rates and quality of services. The BiH micro-finance industry has become a world leader. The new law allows NGO foundations to set up commercial activities, including lending and insurance companies, providing that the foundation maintain majority interest. This enables the current NGO foundations to bring in equity investors through subsidiaries – the foundation structure is proving to be a challenge, since in essence these foundations have no owners. This law also caps loans issued by NGO foundations to 10,000 MK, down from the previous cap of 30,000 MK. The objective was listed as ensuring that tax exempt status applied only to institutions that were indeed engaged in social lending. Given the crowding at the lowest end, institutions have been moving up market into the SME sector, which requires modification of lending practices and assumption of a corporate (non tax exempt) structure.

MFI licensing, regulation and supervision has been brought under the central bank's bank supervision process – viewed as a positive development by market participants – this process needs to be rationalized to avoid disruption of the existing successful business model of these institutions. With formal licensing and supervision within the central bank, it may now be appropriate for these institutions to be given direct access to the credit bureau and to the property registration process that is already available to the banks. These issues are likely to be of interest to the PARE program.

Bottom line: the existing financial system is moving solidly towards closing the “missing middle” for credit worthy SMEs. There is no shortage of expertise within the financial system – due to the pre-existing excellent educational system, USAID's past higher education programs that have been highly successful in developing Bosnian staff that are increasingly showing up in senior leadership positions within the financial sector, and the import of expertise, management and systems through foreign investment in the financial sector.

Expanding Access to Finance

A key objective of the upcoming project is to expand access to finance, particularly for small and medium enterprises that are or could export, in the process aiding BiH's balance of payments, expanding the employment necessary to reduce poverty and enhance social stability, and generating the tax receipts necessary to fund government services to the public.

As this report found, the banking system in BiH is well developed, and may even be the most developed part of the economy. Outstanding systemic issues in the financial sector are being addressed in the upcoming Partnership for Advancing Reforms (PARE⁹) program, which seeks to flexibly respond to requests for assistance in implementing essential reforms to the financial sector enabling environment as the political will to do so develops.

The SME Support Project Concept Paper identifies the following:

Assist SMEs in securing finance from commercial outlets for expansion of their enterprise as well as to cover existing costs associated with production and marketing. Access to modern commercial financing (short and medium term lending) is a key component to the ability of a SME to plan and grow in today's economy. The BiH financial system is able and willing to fund SME development, however, SMEs are unable to tap into this due primarily to a lack of knowledge on how to properly prepare and market their enterprise to lending institutions. Under this new activity, assistance may include providing training to SMEs on proper business plan development, packaging financial materials for commercial banks, and other types of financial assistance training. Types of financial assistance that may be targeted include short and medium term instruments such as warehouse and inventory receipt programs, equipment leasing, accounts receivable financing, and other traditional finance mechanisms.

The section on Key Market Constraints starting on Page 5 identifies the challenges. The factors that drive up market risk and cost are:

| Challenge | Objective | Approach |
|--|---|--|
| <i>Credit Information</i> | | |
| The CBBH credit bureau does not provide non-bank origin data that would support market entry of new borrowers, and is not accessible by all licensed financial institutions. | Individuals and companies can use their track record of honoring financial obligations to expand access to credit and lower cost. | Work with CBBH to expand credit bureau services to international standard range of information to all with a legitimate reason for accessing it. |
| The CBBH credit bureau does not enable commercial credit checkings – these would facilitate development of commercial relations between companies, within BiH and cross border, that have not previously known each other. | Companies able to verify credit standing of potential business partners, domestically and internationally. | Work with CBBH to link credit bureau with international networks and open access to corporate inquiries on credit score. |
| <i>Tax Regime</i> | | |

⁹ Pare is "money" in Bosnian.

| Challenge | Objective | Approach |
|--|-----------|--|
| The tax regime discourages the use of the accurate company accounting practices that are essential for a prospective borrower to document cash flow and debt service capacity to a potential lender. Tax statements cannot be relied on to demonstrate income. | | Fiscal project |
| VAT pull back not functioning, increasing effective tax rate, undermining regional competitiveness. | | |
| | | |
| Impediments to using real estate as collateral: process, cost and market valuation. | | Collaborate with GTZ, as appropriate, and the International Real Property Foundation to build on the current cadastre system to produce a modern property and ownership recording system that would form the base for improved certainty of property location, description, ownership and liens, including on properties under construction. Design should be for a single national system with nodes as necessary to conform to regional divisions. |
| Impediments to registering companies: process and time. | | Collaborate with DfID, as appropriate, to rework a national internet based company registration process and publicly available company database. |
| SME managements have little ability to accurately present their companies and business to potential lenders – support is either expensive or ineffectual. | | Re-activate the previous successful process of bringing potential borrowers and banks together, this time in the form of a web based LendingTree.com approach to leading applicants through developing loan applications, including using a question and answer approach to developing a basic business plan (or rather explanation of their business) and financial data, including a cash flow analysis that demonstrates the expect incremental income to be generated through use of the funds requested and its timing, so as to demonstrate the source of repayment. |
| Services offered by banks in other countries in the region, particularly export finance and seasonal finance, are not offered in BiH, due in part to the factors above. | | |

| Challenge | Objective | Approach |
|-----------|-----------|----------|
| | | |

Discussants

| Affiliation | Representative |
|--|---|
| Chemonics International | Stephen Farkas, Chief of Party, Streamlining Permits and Inspection Regime Activity (SPIRA) Boris Maslo, Commercial Lawyer, SPIRA |
| Central Bank of Bosnia and Herzegovina | Amir Hadžiomerađić, Head, Economic Research and Statistics Department |
| Emerging Markets Group (EMG) | David King, Chief of Party |
| IFC International Finance Corporation | Ivana Curic, Operations Officer, PEP – Southeast Europe Sanjin Arifagić, Associate Operations Officer, Advisory Services Southern Europe |
| Prizma Micro | Kenan Crnkić, Executive Director Jure Žigo, Operations Manager |
| Raiffeisen Leasing | Izmira Aličić-Tuka, Executive Director Belma Sekavić-Bandić, Director |
| Volksbank | Reinhold Kolland, Director and Vorstand Chairman Nedim Šahović, Head of Corporate Banking |
| UPN Association | Mirza Mohansilović, President |
| USAID/Sarajevo | Gregg Wiitala, Supervisory Private Enterprise Officer Amira Vejzagic Ramhorst, Development Assistance Specialist Vladimir Milin, Development Specialist and CTO |

Questions:

- What accounting software and service support exists?
- What loan products do the banks have available?
 - Leasing?
 - Inventory finance?
 - Receivables finance / factoring?
 - Cash flow lending for working capital?
 - Export finance?
- What capacity do the banks have to expand lending?
- What information do the banks request from potential borrowers?
- Are the banks conducting site visits?
- What are the banks' lending policies?
- What are the predominant reasons for turning down loan requests?
- Why is DCA needed – what risks are unacceptable without it?
- What regulations impact lending?
- What insurance exists?
 - Vehicle
 - Fire/casualty/business interruption
 - Transit
 - Liability
 - Key man
 - Health
 - Life
- How effective is the bankers' association?
- How effective is bank supervision?
- Can the statistics be updated to 2007?
- What are the central bank's objectives for the financial industry?